

## APPENDIX

Notes for FOMC Meeting  
April 1, 1986  
Sam Y. Cross

For four weeks after the last FOMC meeting, the dollar continued to decline. At its low point around mid-March, it was more than 6 percent below the levels of mid-February and had reached a postwar low against the Japanese yen. Thereafter, in the following two weeks the dollar recovered somewhat. By this morning as compared with the mid-February levels, it was down a percent or so against the Continental currencies, and down by about 4 to 5 percent against the Japanese yen and the pound sterling.

During the intermeeting period, the exchange markets for the dollar were in a delicate balance. The dollar had already declined a substantial amount from the highs of a year ago. Yet there was little evidence of any adjustment in the current account positions of the U.S. or other major countries. Under these circumstances market participants were especially attentive to statements by public officials, or to any other evidence that might suggest how much more exchange rate adjustment the U.S. might desire and how much the other major countries might tolerate.

In the United States, Congressional testimony after the last FOMC meeting by the Federal Reserve and by the Administration left the impression in the market that U.S. authorities would not actively try to push the dollar down, but would not intervene to resist some further, orderly decline. The round of official interest rate reductions that took place early in March did not alter the market perceptions. On balance, the cuts did little to change interest rate differentials and, having been widely anticipated, they had little impact on exchange rates.

In Japan, questions began to be raised about whether the rise in the yen had not gone far enough. Press commentary there focused on the impact of the yen's rise on small- and medium-sized exporters, and whether, in these circumstances, the government's forecast of growth for the new fiscal year would be achieved. However, the dollar continued to fall, and when it reached new postwar lows, below Y175, there were repeated statements by a number of Japanese authorities expressing their view that the yen may have risen too far against the dollar. Market participants became wary of possible official action to limit the yen's rise. Against this background, when reports that the Bank of Japan was buying dollars in New York swept through the market, the reaction was swift and the yen weakened against the dollar back to around the Y180 level.

As for the European currencies, there were episodes of speculation as market participants considered the possibility that a new conservative government in France would devalue the franc shortly after the March 16 elections, and there were speculative purchases of marks against the traditionally weaker EMS currencies in anticipation of an EMS realignment. The mark's strength was curbed by heavy intervention by the Bundesbank's partner EMS central banks. We thought there might be some unwinding of positions within the EMS today, after the long weekend, but there has not been much.

The intermeeting period ended with dollar rates on balance marginally lower against the Continental currencies over the period as a whole. Against the yen, the dollar has eased more significantly. Looking ahead, market participants are aware that with the sizeable declines we've seen in U.S. long-term rates, the long-term interest differentials favoring the dollar have continued to narrow, in some cases substantially, and this leaves open the question of whether

those differentials will continue to be adequate to attract the needed funds from abroad. Another factor to be taken into account is that as we move toward the Tokyo summit in early May, the Japanese authorities may be very reluctant to see the yen either strengthen very much or weaken very much.

Notes for FOMC Meeting  
April 1, 1986  
Peter D. Sternlight

Since the February meeting, the Domestic Desk's open market operations have sought to maintain about the degree of reserve pressure prevailing shortly before that meeting date. Reserve paths were constructed based on \$300 million of seasonal and adjustment borrowing. Day-to-day implementation sought to be accommodative while also avoiding any strongly aggressive sense of easing. About midway through the period the discount rate was reduced by 1/2 percentage point to 7 percent and prevailing Federal funds rates came down by a roughly comparable amount--from a range around 7 7/8 percent in the early weeks of the period to more like 7 3/8 percent later on. So far in the current period, with the benefit of rather comfortable trading levels last Friday, but also a tight day on the quarter-end yesterday, the rate is averaging about 7 3/8 percent.

Operations were carried out against a background of mixed developments on the monetary growth side--M1 perked up quite strongly, especially in March, and is now somewhat exceeding its annual growth cone and the 7 percent November-March pace sought by the Committee. M2 also accelerated but more moderately, and it remains a little to the low side within its annual range as well as in respect to the

anticipated November-March pace. M3 continues near the middle of its annual range and close to the expected four-month pace. Economic news was also mixed, suggesting on balance continued growth but at a more modest pace than appeared to be unfolding in the early weeks of the year. More dramatically, price developments, especially for oil, were distinctly on the soft side and taken together with news on the economy and the sense of an accommodative monetary policy this produced a large decline in interest rates across all markets and maturity areas.

Nonborrowed reserve levels came close to path throughout the period. Borrowing was nearly \$600 million in the first full maintenance period of the interval largely because of some sizable weekend borrowings related to wire problems, but in the other two full periods borrowings averaged in the \$230 million area--somewhat under the \$300 million path level. The three full periods averaged about \$350 million. So far in the current period, through Sunday, borrowing averaged about \$220 million. Excess reserves ran somewhat above their \$800 million allowance in the first full period, when borrowing also was high. In the next two periods, excess came out fairly close to the revised \$900 million allowance used in constructing the paths--a revision made in light of recent higher prevailing levels of excess reserves.

The System's outright purchase and sale activity was concentrated at the beginning and end of the period. In the opening week or so we sold to foreign accounts, or redeemed, a little over \$900 million of Treasury bills, as reserves were still being supplied by a run-down of Treasury balances. In the final few days, looking toward large upcoming seasonal needs, the System bought about \$400 million of bills from foreign accounts. Repurchase agreements were employed a dozen times, mainly in the form of passing through foreign orders to provide reserves flexibly on a temporary basis, while matched sale-purchase transactions in the market were used nearly a half-dozen times to extract reserves temporarily.

With large reserve needs still ahead, particularly after the mid-April tax date which is expected to produce a bulge in Treasury balances at the Reserve Banks, both outright and repurchase activity is likely to be required in substantial size in the next intermeeting period.

The drop in oil prices was the dominant factor bringing interest rates down over the recent period, with an appreciable assist from the market's sense of relatively modest economic expansion, and of an accommodative monetary policy punctuated by the discount rate cut. The oil price drop not only affected current price index estimates but also seemed to make the recent

past declines in inflation appear much more durable, thus reducing anticipations of future price increases. Foreign buying of securities, especially from Japan, remained a plus factor and expectations of such buying got a boost from a liberalization of Japanese rules on the extent to which some of their financial institutions can buy foreign securities. The powerful rally in Treasury bond prices halted temporarily in mid-March and backed up a bit when it appeared that oil producers might get their act together and curb production to firm prices. When the OPEC talks floundered, sensitive oil prices fell back and the bond rally resumed.

For the entire interval, yields on long-term Treasury issues fell about 170 to 190 basis points. This brought the yield on the latest 30-year issue, which had been auctioned on February 6 at 9.28 percent down to about 7.45 percent, and 7.40 early this morning. There was a particularly steep drop for the latest 20-year bond, as the Treasury decided not to auction a 20-year issue in its latest round of coupon financing in order to conserve then-remaining bond issuance authority for the more popular 30-year slot. (The Congress subsequently enlarged the bond authority but the Treasury chose not to reinstate the 20-year, at least this time around.) Yields on short to intermediate Treasury coupon issues were down about 100 to

160 basis points. Even without the 20-year issue, the Treasury raised about \$21 billion through coupon offerings during the period.

In the bill market, rates came down a somewhat more moderate 75-95 basis points--much of it in the wake of the discount rate reduction. Three- and six-month bills were auctioned yesterday at about 6.35 and 6.32 percent, compared with 7.18 and 7.23 percent just before the last meeting. Bills were being paid down through most of the interval--a net of nearly \$10 billion--although this does not count the \$15 billion of short-term cash management bills to be auctioned today for payment this Thursday. At times, we heard comments suggesting some flight-to-quality type demand for bills, particularly as plunging oil prices raised questions about the viability of banks with heavy energy portfolios, but this tendency was not very pronounced.

In other markets, yield declines were generally somewhat less than those for Treasury issues. In the corporate market, this reflected the effects of a huge increase in offerings, stimulated by lower rates, which led to occasional market indigestion. Net, long-term corporate yields were down roughly a percentage point. In the tax-exempt market the yield decline was overshadowed by tax reform developments, including an agreement

by key congressional committees to delay the effective date of restrictions on public-use tax-exempt issues. The tax-exempt market came to a virtual halt at one point when it appeared that the Congress might subject income from all state and local issues to the alternative minimum tax. The proposal was soon voted down and some equanimity was restored although a scar remained. A broad index of tax-exempt yields fell about 50 basis points over the period.

In other short-term markets, CDs, commercial paper and bankers' acceptances generally came down about 45-75 basis points in yield, while bank prime rates fell 1/2 percentage point.

The extent of the recent market rally has left many pundits scratching their heads as to what may lie ahead. Some feel that continuing evidence of subdued inflation could bring even further rate declines. Others believe the drop may be overdone already, especially if the economy's tempo picks up in the second half of the year, as many anticipate. There is also a fairly widespread feeling that the existing rate structure already takes for granted some further evidence of official accommodation.

On a housekeeping note, I should mention that the Desk recently suspended its trading relationship with Northern Trust Company, one of the 36 primary dealers. This action, which is

not publicly announced, was taken because Northern's overall level of market-making activity has fallen well short of our standard for primary dealers for an extended period. If their activity does not show prompt improvement, we expect to drop them from the published primary dealer list.

Meantime, there are about 15 firms in various stages of declaration or aspiration seeking to become primary dealers, about half of them foreign. As these firms reach a respectable threshold of market-making activity and satisfy other primary dealer criteria, we start taking daily reports from them as a first step on the way toward qualification as primary dealers. We began taking such daily reports from four firms in January and plan to add three more this week. No actual addition to the published primary dealer list has been made since July 1984, and probably none will be made for at least another few months.

JLKichline  
April 1, 1986

FOMC Briefing

Information available since the last meeting of the Committee has provided conflicting signals on the course of the economy. Our reading of the situation, however, has led us essentially to maintain the projection of real GNP growth at about a 2-1/2 annual rate during the first half of the year. For later this year and in 1987 the forecast has been strengthened, associated with the expected stimulus from lower levels of long-term interest rates, the price of oil, and the foreign exchange value of the dollar.

For the first quarter of the year, a good deal of information is missing and what we have available points to diverse developments in various areas of the economy. The labor market surveys in January and February showed strong growth of payroll employment on average, and further gains in hours worked. The increases in employment were again concentrated in the trade and service sectors, with the number of manufacturing jobs actually dropping in February. Industrial output is expected to show little growth for the quarter as a whole, given a decline in February and limited physical product information that suggests a sluggish performance of production in March.

Consumer spending in the first quarter is expected to have expanded moderately. Although retail sales excluding autos and nonconsumer items grew little in January and February together, they remained above the fourth-quarter average owing to the spurt in December. Auto sales apparently averaged well above the depressed rate of the preceding quarter, contributing importantly to the overall rise in consumer spending.

The auto sector, however, seems unlikely to be a source of strength in coming months. Domestic sales levels were sustained in the first quarter by various incentive programs but inventories continued to mount to very high levels. In light of recent sales experience, it seems clear that the domestic industry will have to pare production schedules to bring stocks into better alignment with sales and that is reflected in the staff forecast. In fact, General Motors has just announced some reduction in scheduled assemblies.

The housing sector, by contrast, is booming. Housing starts surged in the January and February period and home sales generally have been high under the impetus of the considerable decline in mortgage interest rates. We expect some weakening in multifamily structures in view of high rental vacancy rates, although single-family starts should be strong enough to hold residential construction at a high level over the forecast period.

In the business fixed investment area, it seems likely that outlays declined appreciably in the first quarter. Shipments of nondefense capital goods were weak on average over January and February, probably associated with the burst of outlays late in 1985 prompted by possible tax changes. Oil well drilling activity is in process of a major decline and that should hold down nonresidential structure spending in the near term. The staff is expecting a little growth in business investment in real terms over the balance of the year, but for the year as a whole such spending seems likely to be about flat.

Adding up the various pieces for the first quarter gives the staff an estimate of about 3 percent real growth. Roughly half of that increase is attributable to developments in net exports, notably an expected drop in the volume of oil imports after the surge in the fourth quarter. We have few reliable data on this score, but oil imports are falling.

Altogether, recent indicators of activity do not provide a comfortable sense of solid economic growth. Nevertheless as we get beyond the next few months, the staff forecast shows a stronger expansion pattern emerging, with real GNP increasing above a 4 percent annual rate in the second half of 1986 and a bit above 3 percent next year. The expected growth is somewhat larger than we had been

forecasting and reflects three factors. First, long-term interest rates have moved to lower levels than we had anticipated earlier, and they are expected to add some stimulus to interest-sensitive sectors. Second, the foreign exchange value of the dollar is now nearly 30 percent below its peak early in 1985 and we have assumed a further decline over time, reaching a lower level than in our last forecast; that is expected to add to growth of net exports, particularly next year. And finally, oil prices are now assumed to settle around \$16 per barrel, instead of the \$20 per barrel previously, and that too is expected to be a net stimulative force.

As for inflation, recent information has been quite good. Sharp declines in food and energy prices led to declines in both the PPI and CPI for February and energy price drops are expected to hold down inflation in coming months as well. For 1986 as a whole, the GNP fixed-weighted deflator is projected to rise about 3 percent, a downward revision of one-half percentage point. In 1987, however, the favorable shock on prices from the energy sector begins to dissipate while the adverse price effects from the falling dollar mount, and slack in labor and product market declines. As a consequence the GNP fixed-weighted deflator is projected to rise at about a 4 percent rate.

Perhaps the most surprising change in financial conditions since the last Committee meeting has been the further spectacular drop in long-term interest rates. The 30-year Treasury bond has dropped by about another 1-3/4 percentage points, and is now--at around 7-1/2 percent--more than 4 percentage points below where it was in the early part of last year. The decline in bond yields has again been much greater than in short-term rates--when the normal relationship is quite the reverse--indicating a significant response in bond markets that has been to a large extent independent of current monetary policy. On balance, since the last Committee meeting short rates have dropped only about half as much as long rates, and similarly since early 1985. In consequence, in terms of the yield curve, we have witnessed a marked further flattening from about a 3 point margin of long over short-term rates in early 1985 to a 2-point margin in very early '86 and then to a one-point margin currently.

The natural question in a monetary policy context is how these rather dramatic developments may have positioned nominal interest rates in relation to attainment of both the economy's long-term growth potential and reasonable price stability over time. That question involves assessment of how the downward adjustment in nominal rates is divided between changes in inflationary expectations and in real rates, in comparison with changes that may also have occurred in the expected real return on capital spending or, in the short run, on inventory outlays.

Answers to the question are necessarily conjectural in large degree, since much depends on making judgments about such subjective factors as changing inflationary attitudes over the short and long runs. It also depends on such difficult-to-measure concepts as the marginal productivity of

capital and the nation's long-run growth potential, as well as on businessmen's attitudes as embodied in the optimism or pessimism with which the return on capital is viewed.

No doubt the drop in market interest rates since early 1985 reflects both downward adjustments in inflationary expectations and in real rates, but it is not clear how much of each. One much-cited survey indicates that reduced long-run inflation expectations would account for only about 10 to 15 percent of the 4 point drop in bond yields since early last year, thus implying a very sharp drop in real rates. But there is always doubt about the reliability or significance of any particular estimates of inflation expectations from surveys.

Perhaps a clearer sign of a drop of long-run inflationary expectations is from the flattening of the yield curve in a period of declining short-term interest rates and relatively substantial growth of M1. In the past, yield curves have flattened in the process of monetary policy tightening. A substantial flattening in a period of monetary accommodation--encompassing the two discount rate cuts of last May and this March--is unusual and, to me, suggestive of the possibility that long-run inflationary expectations may have shifted downward more rapidly in actual market practice than the survey suggests. This year the downward adjustment in inflationary attitudes was triggered by oil price developments. I would guess that these attitudes are quite unstable, however. Bond and stock markets could undergo a very substantial downward readjustment in prices should the oil price decline be reversed in a significant way, or should a sharp further drop in the dollar spur noticeable import price increases.

To the extent that there is a real component to the drop in long rates since early 1985, I would suspect that to a considerable extent it

represents a response to the more restrained budget outlook in the wake of Gramm-Rudhman and to the noticeable slowing of the economic expansion beginning in the second half of 1984. As a quite modest real economic performance continued through 1985, it probably led to a downward re-evaluation of the expected long-run real rate of return because productivity trends and long-run real growth prospects came to be assessed more realistically.

Monetary policy actions also of course affect nominal and, certainly in the short run, real interest rates. Policy or expectations about policy can for a time drive real rates above or below long-run equilibrium in the process of restraining or encouraging reserve and money growth, assuming that long-run inflationary expectations do not adjust immediately. It seems probable that last year's discount rate reduction, for example, helped exert some downward pressure on real long-term rates through encouraging a reduction in real short-term rates. The impact of the most recent decline in the discount rate is less clear. It took place in the wake of the sharp break in oil prices--a break that had a favorable impact on long-run inflationary psychology and that also should have had an even greater downward impact on inflationary expectations over the short-run. In that context the recent declines in nominal short-term rates could in themselves involve no or little real decline, given near-term price performance. I would not conclude from that, however, that actual and expected real long rates were unaffected. The market's expectations could well be that policy would in effect become or need to be less tight over the intermediate term because inflation has become less of a danger and therefore less real restraint is required to suppress it.

The sustainability of the present yield curve and the nature of the potential adjustment in it depends in part on the extent to which recent rate movements have in practice provided real incentives to spending. Some

upward adjustment in real long rates through a rise in nominal rates is more likely in the degree that real long rates have dropped by more than would be justified by the expected real return on capital and prospects for fiscal restraint. Such a drop could have occurred, for instance, because the recent rush of funds into bond markets, impelled say by a re-evaluation of economic circumstances and of future monetary policy, has, as often happens in such circumstances, driven nominal and implied "real" rates temporarily below underlying equilibrium levels. A correction can occur either as investors come to back off or as the lowered rates stimulate spending and credit demands, as in the mortgage market.

A downward adjustment in short rates would be more likely, on the other hand, in the degree that they (or indeed long rates) are currently high enough in real terms to act as a substantial restraint on near-term economic activity through, say, a high real cost of financing inventories or through more general business hesitancy as relatively high real short-term borrowing costs cast some uncertainty over the long-run outlook. If that were the case, it should be manifested of course in a weak near-term economy and relatively slow growth in at least those monetary aggregates less influenced by sensitivity to changes in nominal interest rates.

The policy alternatives before the Committee today can be viewed in part in this context. Alternative A contemplates an easing in bank reserve and money market conditions that would tend to exert downward pressures on short rates and therefore reduce the odds on a back-up in long rates, and indeed probably encourage a little further decline in those rates. Such a policy would be consistent with a view that at least the near-term economic outlook is weak, that inflation dangers are down substantially, and that the restraint of the M1 long-run range should be given little weight with M2 and

M3 within or below their long-run ranges. Alternative B would, on the other hand, generally keep short-term rates unchanged over the near term. Such a policy approach would be consistent with a view that the near-term economic outlook, or at least the intermediate-term, is reasonably strong. It is also consistent with the view that long-term inflationary pressures are enough greater relative to short-term pressures at this point--given the downtrend in the dollar, budget uncertainties, and the possibility of a reversal in oil prices--so that the risk can be run, consistent with satisfactory economic performance, of restoring more upward tilt to the yield curve through the potential for some long-term rate readjustment.